Bilateral Tax Treaties and Foreign Direct Investment in India: Evidence from Mauritius

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Abstract

The international tax treaties have significant impact on the flow of Foreign Direct Investment (FDI) of a country. The Double Taxation Avoidance Agreement (DTAA) between India and Mauritius has served as a gateway to funnel FDI to India through Mauritius. During last twenty five year there is a phenomenal increase of FDI inflow to India from Mauritius. Because of DTAA the offshore companies are able to avoid and evade taxes arise from making securities transaction .Mauritius is used as mailbox to invest in India by third country companies .The liberal fiscal and economic policy of Mauritius along with DTAA facilitate the third countries companies to route their venture to India through Mauritius. 36percent of the total FDI has in flowed from Mauritius during 2000-14. The total FDI flow is 80808.09 million US dollar during this period .Similarly in the recent time the FDI from India has significantly increased to Mauritius .Indian investors are using Mauritius as a launching pad to target African market. The total FDI out flow to Mauritius is 4428 US million $ which 12percent of the total FDI out flow from India in the year 2013-14. Against this back drop the present study is based. The objective of the study is to study the role of bilateral tax treaties on the flow of FDI between India and Mauritius.

Key Words: FDI, Tax Treaty, DTAA, and Capital gain.

Introduction

The FDI flows depend upon both the domestic country and other counterpart. Both countries should have provided a favourable conducive environment to FDI. Then and that only the smooth flow of FDI is possible .The FDI flows have been guided by the micro-economic variables , policy variables and tax treaties between the two country . Bilateral tax treaties are an important factor of economic reform to avoid the problem of international double taxation. It directly affects the profitability of the investor. Normally the investors wish a hassle free low tax rate as the tax plays an important portfolio of the investment process. The international tax treaties have significant impact on the flow of Foreign Direct Investment (FDI) of a country. The Double Taxation Avoidance Agreement (DTAA) between India and Mauritius has served as a gateway to funnel FDI to India through Mauritius. During last twenty five year there is a phenomenal increase of FDI inflow to India from Mauritius. Because of DTAA the offshore companies are able to avoid and evade taxes arise from making securities transaction .Mauritius is used as mailbox to invest in India by third country companies .The liberal fiscal and economic policy of Mauritius along with DTAA facilitate the third countries companies to route their venture to India through Mauritius. 36percent of the total FDI has in flowed from Mauritius during 2000-14. The total FDI flow is 80808.09 million US dollar during this period .Similarly in the recent time the FDI from India has significantly increased to Mauritius .Indian investors are using Mauritius as a launching pad to target African market. The total FDI out flow to Mauritius is 4428 US million $ which 12percent of the total FDI out flow from India in the year 2013-14. Against this back drop the present study is based.

Methodology:

The objective of the study is to study the role of bilateral tax treaties on the flow of FDI between India and Mauritius. In order to the objective the DTAA has been taken into consideration. Both inflow and outflow of FDI from both countries are taken into consideration .The study is based on secondary data. Last ten year data have been taken into consideration. The data are analyzed with help of simple statistical tool such as percentage ,graph ,chart, compound annual growth rate and etc The study is broadly divided into six sections such introduction, methodology, DTAA, Analysis, issues on DTAA and conclusion

The Double Taxation Avoidance Agreement (DTAA)

There are 2976 bilateral tax treaties in the world by the end of 2010 (UNCTAD, 2011). All these treaties are concerned about the mutual trade and international tax agreement. After 1980 the Asian and Pacific countries have intensified their activities related to bilateral trade. Under section 90 of Income Tax Act 1961 India has entered into bilateral tax treaty with 88 countries so far. Out of which 85 are in force now. Under section 90 of Income Tax Act 1961 the Government of India has entered into the DTAA or bilateral tax treaties with other countries. It gives a protection to the tax payer against the double taxation. It discourages the double taxation as well as encourages the free flow of global investment. According to section 90 of Income Tax Acts a treaty may be entered into a) for grant of relief in respect of income which is taxed in both countries, b) for the avoidance of double taxation on the income, c) for exchange of information for the prevention of evasion or avoidance income tax and d) for the recovery tax. Section 91 provides relief to the tax payers who paid tax to a country with which India has no DTAA .Double Taxation relief is provided by the combination of the exemption method and tax credit method in Indian tax treaties(Murthy & Bhasin, 2014)..Blonigen and Davies (2000) had conducted a study on the impact of bilateral tax treaties and its effects on the flows of FDI between and US and other countries. They observed in their work that bilateral tax treaties had a positive impact on the flow of FDI .Over a period of time there is significant increase in the flow of FDI. According to Harper (2009) DTAA is the most beneficial treaties among all other treaties that both India and Mauritius have .Because of DTAA Mauritius has been able to obtain a niche in terms of FDI in India. DTAA is an excellent mechanism for economic cooperation (Gunuputh, 2014)

There must be an overall conducive environment to FDI. India has made tax treaties with other country in order to make the economy internationally competitive and vibrant. In the recent two decade it has been observed that bilateral treaties act as a panacea for inflow and outflow of FDI for country. The tax treaties are mainly designed to avoid double taxation and develop mutual trade co operation.

There is a long history of treaty between India and Mauritius. During the colonial times also both countries share a DTAA. Both the countries had a strong tax treaties relationship as result of which in August 24 1982 both countries entered into DTAA, It provides a platform for the corporate sector of the countries for avoidance of double taxation and prevention of fiscal evasion with respect to taxes on income and capital gain and for encouragement of of mutual trade and investment. The DTAA is not merely considered as tax treaty of double tax avoidance but it is as equally important to prevent of fiscal evasion, encouragement of mutual trade and investment in both the countries. As per the tax treaty the capital gain earned by an entity is taxable in the country of residence. The treaty has specified that the capital gain derived from the sale of Indian companies by the resident of Mauritius would tax only in Mauritius and not in India. Mauritius has stared offshore banking in 1988. It is considered as the stepping stone for the development of the economy. It plays a crucial role for the development in financial service sector. This step might transform Mauritius from sugarcane economic to financial services provider economy. The government of Mauritius promulgated the Mauritius Offshore business Activities Act 1992 to regulate the offshore business in the country. The Acts allow the foreign companies to register in Mauritius for investing abroad. They would be considered as a resident as per Income tax Law of Mauritius. As per the Income tax law of Mauritius the offshore companies within the definition of resident are under zero percent tax .This is main reason for the third countries investor are routing their investment through Mauritius to India. Coincidently the Government of India has adopted the policy liberalization policy in 1991.

Mauritius has no capital control, stable currency, low corporate tax rate and large number of DTAA and bilateral agreements with the other countries creates a conducive climate for financial sector for business. Mauritius has consistently securing higher ranks internationally so far as the investment climate is concerned. The overall ranked of Mauritius is 17 out of 183 countries (World Bank's Doing Business Survey 2014). Companies holding a Category Global Business License 1 are treated as tax resident as per Income Tax Act of Mauritius .GBC1 has to 15 percent income tax but automatic adjusting tax credit the effective rate is three percent only .On GBC1 neither capital gain tax or withholding tax are levied .

The important bilateral agreement signed between India and Mauritius are Double Taxation Avoidance Convention(1982), Bilateral Investment Promotion and Protection Agreement (1998),MOU on Extradition Treaty (2003), MOU for Cooperation on Consumer Protection and Legal Metrology (2005),MOU on Cooperation in the exchange of Finance Intelligence Related to Money Laundering& Financing of Terrorism (2008)

Analysis:

36 percent of the total FDI to India is coming from Mauritius. It acts as a panacea for the balance of payment crisis, foreign exchange reserves and economic development of the country. The foreign exchange reserves were only 2.8 billion USD in the year 1991. It was gradually increased to 38 billion USD by the end of March 2000. It was sharply increased to 309.7 billion USD by the end of March 2008. It is increased to 3192.39 billion USD by the end of 31st March 2014. A significant credit goes to the bilateral tax treaty signed between India and Mauritius which boost the trade and investment in India. Since 1991 the Government is focusing on the policy of liberalization as a result of which there is significant inflow of FDI after 1991.Table -1 contains the FDI inflow to India during 2001-02 to 2013-14. After 2006-07 there is significant increase in the flow of FDI. In the year 2001-02 the FDI inflow was only 6125 million USD. It was increased to 41738 million USD by end of March 2009. After economic crisis again it stared decreasing .again in 2011-12 the FDI started increasing. The compound annual growth rate (CAGR) of FDI inflow to India during 2001-02 to 2013-14 is13.32 percent. The flow of FDI has played an important role in the development of the economy during the recession period. Similarly during this period there is significant flow of FDI from Mauritius to India .Mauritius is the single largest contributor of FDI after 1991. After 2006-07 the FDI flow from has been significantly increased .Even during economic slowdown period also there is significant flow of FDI from Mauritius .The table -02 contains the detail FDI flow from Mauritius during 2006-07 to 2013-14. The inflow of from USA to India are routed through Mauritius due to tax advantages(Ahar&Marimuthu,2012).The tax rate in Mauritius are lowest as compare to other countries .

Table-1

Flow of FDI to India

Year	FDI inflow (million USD)	Growth in %
2001-02	6125	51.9
2002-03	5036	(-)17.8
2003-04	4322	(-)14.2
2004-05	5987	38.5
2005-06	8901	48.7
2006-07	22739	155.46
2007-08	34729	52.72
2008-09	41738	20.18
2009-10	33109	(-)20.7
2010-11	29029	(-)12.4
2011-12	32952	13.5
2012-13	26953	(-)18.3
2013-14	30763	14.1

Source: Reserve Bank of India, Annual Report Publications 2014

Diagram -1

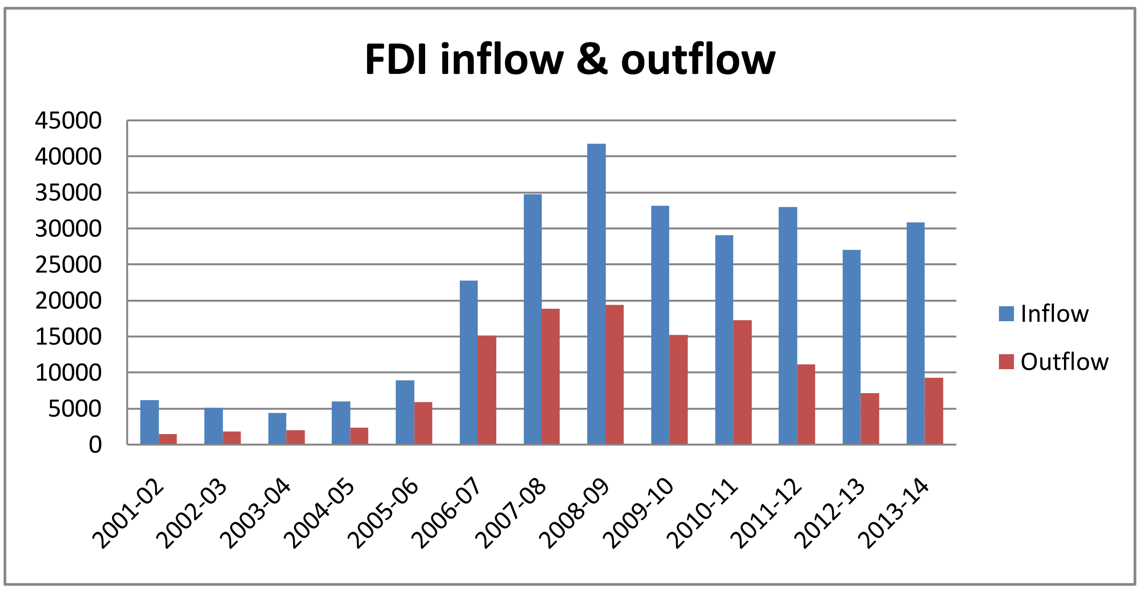


Table-2

FDI flow from Mauritius

Year	Total FDI Inflow(million USD)	Mauritius
2006-07	22739	6363
2007-08	34729	11096
2008-09	41738	11208
2009-10	33109	10376
2010-11	29029	10421
2011-12	32952	9942
2012-13	26953	9497
2013-14	30763	4859

Sources: Reserve Bank of India, Annual Report Publications 2014

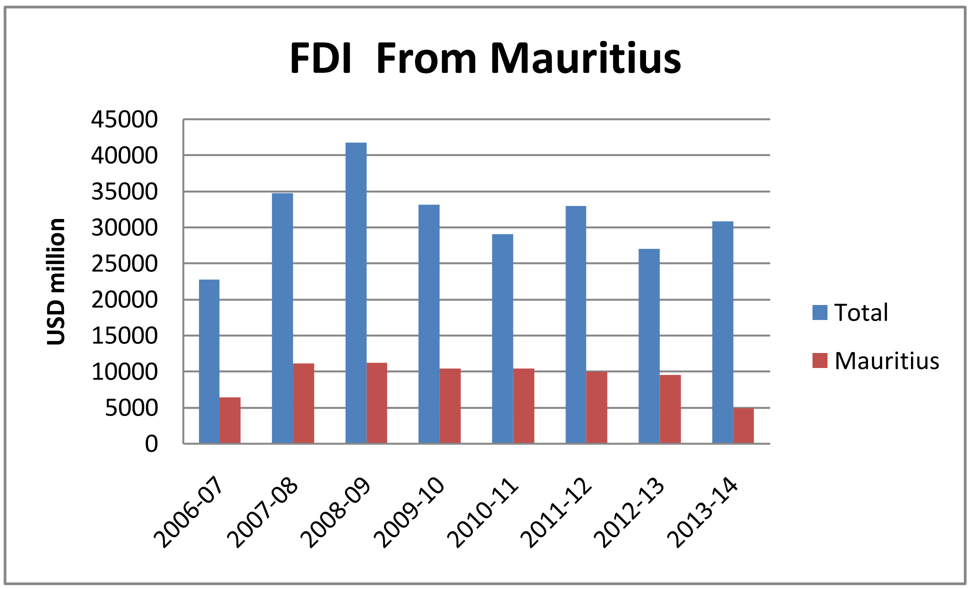
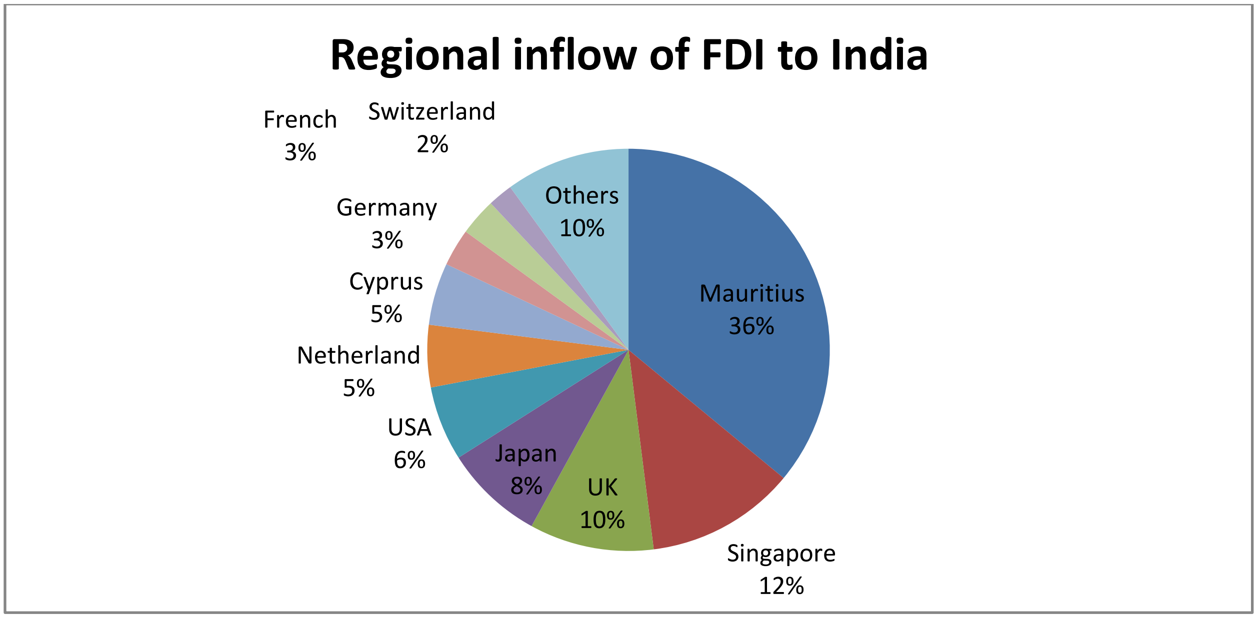


Chart-1



The Chart –I shows the percentage of FDI inflow from different countries to India from 2000-01 to 2013-14.From the chart is observed that Mauritius is the largest contributor of FDI to India. The FDI coming from Mauritius to India till 31st March 2014 is 36 percent of the total FDI. 78525 million USD is coming from Mauritius during 2000 to 31st March 2014. After Mauritius the share of Singapore, UK, Japan and USA is 12percent, 10 percent, 8 percent and 6 % respectively.

Mauritius is low tax country. The tax rate is low. There is no capital gain tax for securities as result of which it is used as a platform for other countries to invest in India .Further a large number of India Companies have been floated shell companies in Mauritius to round trip their investment. An offshore company is treated as tax resident and eligible forgetting benefit of DATT. They pay an annual registration fee of 1500 US$. Their effective rate of tax is around three percent after all adjustment. 90 percent of active funds of offshore company are investing in Indian securities and shares .Since 1992 there is a spectacular growth in offshore sector in Mauritius as Mauritius offshore Business Activities Act (MOBA Act 1992) provides a wide range of attractive investment incentive as well as giving the benefit of tax treaty with other countries.

Table-3 contains the detail of India's outward FDI .It is observed from the table -3 that there is a significant increase in the outward FDI during 200-02 to 2013-14. Since 2007 Outward FDI has increased significantly. Even during economic downturn also the outward FDI in 2009 was at peak. In the year 2001-02 the outward FDI was only 1391 million USD. It was increased to 19365 million USD in the year 2008-09. The compound annual growth rate (CAGR) of outward FDI from India during 2001-02 to 2013-14 is15.64 percent .However a significant amount outward FDI was moved to Mauritius, Singapore, British Virgin Islands and Netherlands. However Netherland is most receipt of Indian outward FDI.The countries wise recipient of outward FDI in percentage has been reflected in the pie chart -2. In the year Mauritius started developing offshore banking with an intension to be the platform to invest in Africa. After that Mauritius is considered as most preferred route to Africa for Indian outward investment.

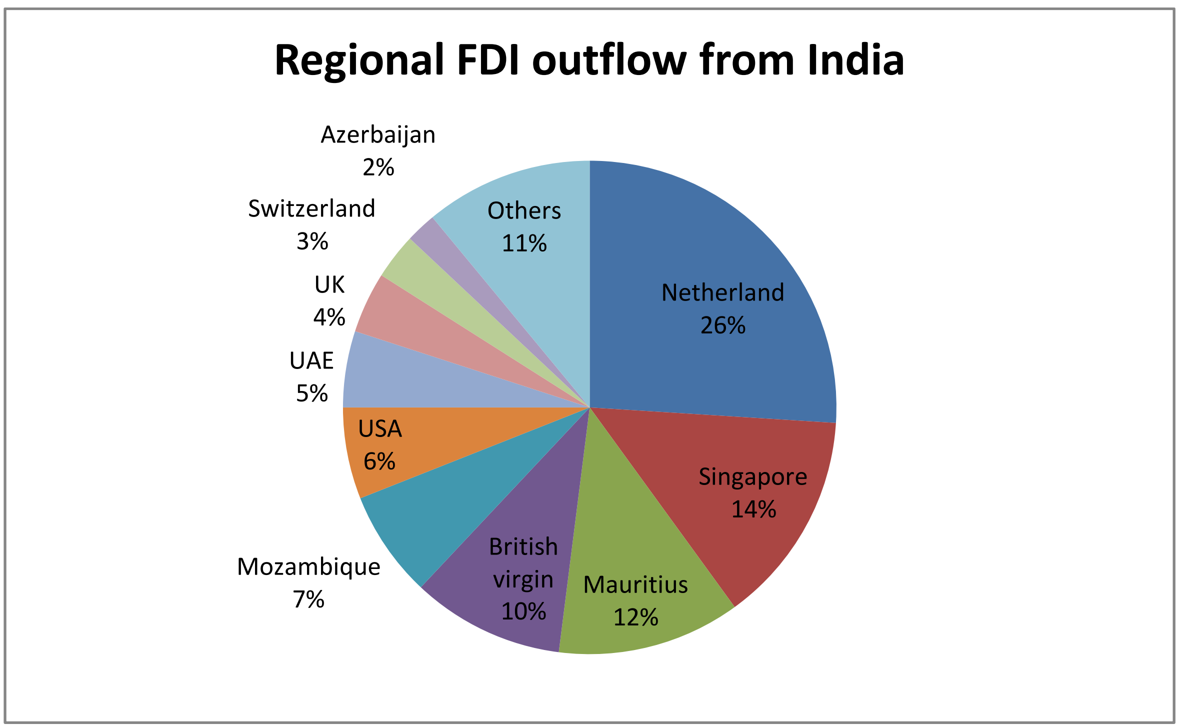
TABLE-3

Outward Foreign Direct Investment from India

Year	FDI outflow (million USD)	Growth in %
2001-02	1391	83
2002-03	1819	30
2003-04	1934	6.3
2004-05	2274	17.5
2005-06	5867	158
2006-07	15046	156.5
2007-08	18835	25.2
2008-09	19365	2.8
2009-10	15144	(-)21.8
2010-11	17195	13.5
2011-12	11097	(-)35.5
2012-13	7134	(-)35.8
2013-14	9199	28.9

Source: Reserve Bank of India, Annual Report Publications, 2014

Chart-2



Controversy on DTAA

DTAA has been attacked criticized several times for different reason as there are alleged abuses and fraud by some Indian investors including round tripping funds and treaty shopping. The investors of third countries location are also using DTAA to avoid capital gain tax through GBC 1 status in Mauritius as result of which Indian counterpart is consistently loosing tax revenue. Now DTAA is day by day becoming a controversial agreement. But Mauritius always wants be a win-win situation out of DTAA. The Mauritius Government ensure the government of India that DTAA will not be misused for illegal activities like money laundering and round tripping of funds .In order to avoid controversy on DTAA Mauritius Government is issuing Tax Residency Certificate (TRC) to those company who are availing the benefit of DTAA. Recent both countries have signed on Tax Information Exchange Agreement. Moreover Mauritius is agreed to Limitation of Benefit (LOB) Clause in a revised pact with India. LOB is to prevent tax shopping and inappropriate use of tax pact by the third country investor by inculcating some strict regulation regarding business, residency and preventing illegal way of avoidance of tax. But Mauritius is keen on Comprehensive Economic Cooperation and partnership Agreement (CECPA) and minor revision on DTAA whereas India is emphasis on DTAA. India is proposing a source base capital gain tax to plug the misuse of DTAA by the Shell formed by the third countries corporate entities. But it is well known fact that both countries are reaping from DTAA since 1992.Since 1982 the tax treaty between India and Mauritius has been subjected to and survived numerous attacks from the revenue authorities, the press, researchers and certain section of the public despite of its legitimacy. Interestingly the treaty has been defended by the same revenue authorities and government at highest political level resulting the survival of the treaty (Desai& Sanghavi, 2014).

Now Mauritius is projecting itself as the gateway to Africa. More India investor are registered for targeting African Market through Mauritius route. Now Mauritius is becoming a gateway for inward and outward investment for India.

Conclusion:

Over the last ten years Mauritius is the largest sources of FDI to India which represent 38% of the total FDI in flow to India. The main reason for this significant inflow might be DTAA between the two countries. DTAA is considered as the most valuable engine for FDI inflow and outflow between India and Mauritius. DTAA has been attacked and criticized several times for different reason as there are alleged abuses and fraud by some third countries investors and Indian investors including round tripping funds and treaty shopping. But DTAA has been defended by the judiciary, tax authorities and political body with minor changes in DTAA. Now Indian investors are using Mauritius as platform for entry to African market as result of outward invest through Mauritius has significantly increased in recent times. From the aforementioned analysis it can be concluded that the bilateral treaty between India and Mauritius plays an important role in FDI inflow and outward FDI .Bilateral treaty acts as an instrument for economic development for both the countries.

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